involving extensive media advertising. telemarketing. direct mail. and special promotions (cash. airline miles. etc.). When spread over the number of sales that arc actually consummated. these costs can amount to hundreds of dollars per customer acquired. I am aware of at least one analysis that has put such cost at "up to $300 to $600 in sales support, marketing and commissions" per customer acquired.[82] The prevailing industry customer acquisition cost represents the fair market value of the customer acquisition services that a BOC provides to its 272 affiliate

63. In the aforementioned decision regarding Pacific Bell, the CPUC, speaking to this very poinr. observed that:

> The significant advantage afforded Pacific's long distance affiliate by Pacific's ability to market its affiliate's service to several million incoming customer service calls per year from its existing local service customers will unquestionably affect the other interexchange carriers. No other interLATA competitor in California has any similar massive opportunity to address incoming calls from potential interLATA customers. PBLD's potentially swift dominance of the intrastate interexchange telephone market could detrimentally impact competition in that sector. However, PBLD's gains will to some extent be moderated by interexchange carrier entry into the local telephone market."[83]

Although the CPUC references Pacific Bell's dominance of the intrastate interLATA market its conclusions apply with equal weight with respect to the interstate interLATA market which is

82. See Borna. Claude. "Combating Customer Churn." in *Business and Management Practices* Vol. 11. No. 3: Pg. 83-85: ISSN:0278-4831. Horizon House Publications. Inc., Telecommunications Americas Edition (March. 2000).

83. *Calif. PUC Decision.* at 263.

what is specifically relevant in DC. Experience in both New York and Texas confirm the extraordinary marketing advantage, *available solely to BOCs*, stemming from their use of this "inbound channel" to "sell" their affiliate's interLATA long distance service to *local service* customers. This advantage has not been overlooked by Wall Street. As a February 8, 2001 Credit Suisse First Boston ("CSFB) report commented:

> We've been watching this industry for almost 20 years and we have never seen consumer share gained at the rate of VZ in NY and SBC in TX (the former 20% share in 12 mos and the latter 18% share in 6 months).[84]

64. In considering whether Verizon DC has satisfied the requirements of Section 272, it is essential that the Commission recognize that what Verizon DC seeks in its application is not simply the right to enter yet another isolated line of business, but the right to *integrate* local and long distance service into a single package, to make the two services essentially indistinguishable from the consumer's perspective, and to leverage its dominance of the local market to similarly come to dominate the long distance market as well. CSFB makes the point profoundly clear in its comparison of (pre-merger) GTE's approach to selling long distance services through a separate CLEC affiliate vs. Verizon's ability to offer long distance services directly to their ILEC customers

> In stark contrast to Verizon's huge and quick *20%* consumer LD share gains in NY State, LD subscribership was flat in the GTE franchise areas in '00 despite GTE's benefiting from similar pre-established branding and billing relationships. The difference is that GTE has not leveraged the inbound channel and also had been running its LD effort through its "CLEC", in effect

84. "VZ Analyst Mtg Provides Comprehensive '01 Outlook." Credit Suisse First Boston, 09:47am EST, 8-Feb-01 ("*CSFB Report*").

forcing customers to switch to the GTE CLEC both their local m i c e from GTE's ILEC and their LD service from another LD customer. Not very successful if you ask us and certainly worthy of change given the empirical evidence that VZ's and SBC's use of the inbound channel and *separate* LD sub (but not bundled with local) have been extraordinarily successful.[85]

As the CSFB report observes. this preemptive use of the "inbound channel" by both Verizon and SBC to "sell" their long distance service to *new* local service customers has been the principal explanation for their extraordinary success in acquiring customers in the first year in which they have been permitted into the long distance business. Indeed, SBC has apparently been sufficiently satisfied with its market performance after having received 271 authority. as it subsequently elected to ***increase*** its interstate long distance rates in Texas. As reported in the *Ft. Worth Star-Telegram:*

Southwestern Bell announced it was raising the interstate rate on its flagship plan from 9 cents a minute to 10 cents a minute for new customers seven months after entering the long-distance market in Texas. Current subscribers will see no change in their domestic U.S calling charges. said Shawn Ramsey. a San Antonio-based spokeswoman for Southwestern Bell. a unit of SBC Communications

Ramsey defended the increase. which doesn't require approval by the state's Public Utility Board. by saying the plan is superior to many offered by the major long-distance services. "We beat the pants off of them," she said. "We've got great rates any way you slice or dice it." Asked if the higher rate reflects a need to boost profits. she said: "We've been in the market about eight months now. We've learned a lot and made a number of changes that reflect what we've seen. And we've changed our plan accordingly.'[86]

85. *Id*

86 "SW Bell raises interstate rate: current subscribers unaffected; PUC approval not needed.'. *Ft Worth* ***Star-Telegram.*** February 2, 2001.

65. It would be difficult **for** anyone to **seriously** contend that a **BOC's** ability **to separately** *and preemptively* identify ***and recommend*** its **own** affiliate's long distance service does not afford it a substantial advantage over its long distance rivals in being the **first** to offer and to ***sign*** up a new local service customer for long distance service. The **FCC itself has recognized the** advantage to an IXC of appearing early (or even first) on the list of service providers **by** its ***express requirement.*** **as** set **forth** in the ***Non-Accounting Safeguards order.*** that the names of IXCs be read to inbound callers ***in random order.***[87] **The** practical effect of the physical impossibility of simultaneously making the BOC affiliate recommendation while contemporaneously reading the full list of available IXCs. together with the BOC's right to make its "recommendation" ***prior to identifying any alternative long distance providers,*** affords it an enormous marketing advantage in selling long distance services. This preemptive **use** of the inbound channel by Verizon to "sell" its long distance service to ***new*** and existing local service customers has been the principal explanation for their extraordinary success in acquiring customers in the first year in which they have been permitted into the long distance **business.**[88]

66. There are a number of reasons why a customer might initiate contact with a **LEC** and. **to** the extent that the Verizon BOC continues to enjoy overwhelming market dominance, most such contacts will inevitably be with Verizon in areas in which Verizon offers local exchange service

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87. *Non-Accounting Safeguards* ***Order.*** 11 FCC Rcd 22046. citing ***In the Matter of Investigation of Access and Divestiture Related Tariffs. Allocation Plans Waivers and Tariffs, Memorandum Opinion and Order.*** **101** FCC 2d ***(1985)*** at ***950.***

88. Verizon has reponed that through the end of the third quarter of 2001. **after just** 21 months since it began offering long distance service in New York, its long distance affiliate Verizon Long Distance has captured 3**1.7%** of the residential subscribers in Verizon New York's service areas. Verizon Press Release. October 30.2001, provided in Attachment **OPC** A-4.

as an ILEC. Contacts initiated by customers would take place where the customer needs to place an order for new telephone service. for an additional access line. or to add or change service features. Customers may also initiate contacts for bill inquiries, repair service. or to obtain information about new services that might become available, such as ADSL.

67. Indeed. at least with respect to these types of sales at the time of the initial local service contact. the BOC need spend little if any resources actually advertising or otherwise marketing its long distance services. The inbound caller has already made the contact with "the phone company" for basic telephone service and, unless that customer is a student of telecommunications industrial organization and regulation. there is a strong likelihood that the customer will simply accept the BOC service representative's "recommendation" as the only and obvious choice Thar selling long distance services to "inbound *local* service customers is a centerpiece of Lerizon's long distance marketing strategy can be reasonably inferred from the behavior of Verizon in other states where it has received Section 271 authority.

The value of Verizon's inbound marketing channel to "sell" its long distance service creates substantial potential for its remonopolization of tbe long distance market.

68 Far from promoting competition in the long distance market. it is likely that Verizon DC's entry into the interLATA market in the District will harm long distance competition and lead to remonopolization by Verizon. In a subsequent section of my affidavit. I present an analysis of rhe financial harms and violations of the federal *Act* attributable to the joint marketing of local and long distance services. The joint marketing planned by Verizon DC, however. must also be addressed in light of this Commission's public interest obligations. As

long as Verizon DC continues to maintain its present position of dominance in the *local* service market and is afforded the opportunity and ability to engage in "joint marketing" with its Verizon long distance affiliate, Verizon DC will soon come to dominate the long distance market in the District. To the extent that the BOC maintains a de *facto* monopoly with respect to the provision of *local* services in part or in all of any jurisdiction in which it has received Section 271(c) authorization. the effect of this preemptive joint marketing opportunity is to permit the BOC to extend its local monopoly into the adjacent. and otherwise competitive. long distance market.

69. Presumably, the principle/theory (if there is one) driving the FCC's and Congress' acquiescence in such "joint marketing" is that *if the local market is competitive* and as such if customers are given real choices as to whom they contact for local service (which is the presumption once the "competitive checklist" has been satisfied). the RBOC then no longer enjoys any advantage vis-a-vis CLECs with respect to selling customers long distance service either. because CLECs are also free to sell long distance service to rheir local service customers. However. as reality bears out. the principle/theory breaks down if the local market is not actually competitive (*i.e.*, if customers have no choice but to contact the BOC for local service and if the BOC retains the right to preemptively market long distance service to those customers), as other long distance providers will be blocked from addressing these customers.

70. The larger the BOC's share of the *local* market. the greater will be its opportunity to preemptively market its affiliate's long distance service to its legacy *local service* customers. And if customers exhibit a disproportionate propensity to select the BOC as their long distance

carrier as a result of this "first to get there" opportunity, then over time the BOC's long distance market share would also be expected to grow *directly and specifically as a consequence of its ability to preempt competing long distance curriers in signing up new customers.*

71. Interestingly. there are strong parallels between the various policy initiatives taken during the 1980s that were designed to open the long distance market to entry by "Other Common Carriers" ("OCCs." defined as interexchange carriers other than AT&T) and the current policy moves toward authorizing BOC entry into the long distance market. in the earlier case. OCC entry and growth were facilitated by several factors, including the requirement that BOCs (and later extended to ILECs generally) provide "equal access" and associated dialing parity to all IXCs.[89] The current analogy to "equal access" is the Section 271(c)(2)(B) 14-point "competitive checklist." The remaining policy initiatives were expressly intended to jump-start long distance competition. to give the OCCS certain specific opportunities to expand their market that would overcome the enormous obstacles confronting any non-incumbent attempting to enter a market long dominated by a single firm.

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89. Others include (a)the requirement that *discounted* access charges apply to OCCS prior to the introduction of equal access in any central office, (b) "balloting" of BOC customers with respect to the choice of PIC and *assignment* of nonresponding BOC customers to OCCs in proponion to the selections made by responding customers, (c) adoption of an "equal charge per minute of use" rule. which deprived AT&T of any opportunity to benefit with respect to access charges paid to ILECs from its size. incumbency or scale economies relative to those of its smaller rivals. and (d) adoption of the so-called "five-mile rule," under which all OCCs locating their points of presence ("POPs") within five miles of an ILEC access tandem would be subject to the same access charges as would AT&T (which was often collocated with the BOC), thereby eliminating any incumbency and preexisting collocation advantages that might otherwise have benefited AT&T. AT&T was also subject to a disproportionately-applied "equal access recover! charge." forcing it to pay a relatively larger share of the costs of implementing equal access than its OCC rivals.

72. The transition to qual access began in 1985 and was substantially complete by the end of **1988.** The **1985** beginning of the transition to equal access is analogous to *a* BOC's initial satisfaction of the 14-point checklist. By the end of the fifth year (*i.e.*, by the end of **1990).** the non-AT&T IXCs had acquired 22.9% of presubscribed lines **nationwide.**[90]

73. In view of the strong parallels between OCC **entry** in the **1980s** and BOC entry **today.** I believe that the ***results*** of the earlier policy paradigm offer a useful and reasonable standard against which the current policy initiatives relative to BOC entry **can be** evaluated. That is. but for the BOCs' ability to exploit their inbound marketing channel. there is no *a priori* reason to expect their rate of market share growth to differ materially from that of the OCCs in the initial years following "equal access." Conversely. evidence of substantially greater BOC long distance market share growth serves to verify the enormous value that Vcrizon and other BOCs obtain solely by virtue of their status *as* dominant local exchange carriers.

74. Verizon Corporation press releases provide information on Verizon's experience in providing long distance service in New York and **Massachusetts.**[91] Approximately 12 months after receiving Section 271 authority in New York. Verizon Long Distance reported a New **York** residential market share of **20%.** After 21 months of providing long distance service in New

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90 Federal Communications Commission. Wireline Competition Bureau. industry Analysis Division ***Long Distance Market Shores Fourth Quarter 1998,*** March, ***1999,*** Table **2.1.**

91 See Verizon Press Releases. dated February **1.2001.** October **30.2001** and January 31, 2002 provided in Anachment **OPC A-4**

York. Verizon reported a New York long distance market share of 31.7%, and at the end of 2001, after two full years of 271 authority, Verizon reported a market share of 34.2%.[92]

75. It is evident through analysis of the long distance market share gains for other BOCs that have attained Section 271 authority that Verizon's experience in New York, as noted above, is not anomalous. Nine months after receiving Section 271 authority in Massachusetts, Verizon reported a long distance market share of more than 20%, and indicated that "Sales results for Pennsylvania, where Verizon began marketing long distance services in late October 2001, are in line with early success rates in other Verizon states."[93] In Texas, where SBC received interLATA authority in June of 2000, SBC reported that after less than 9 months it had acquired 2.1-million of its 10-million local customers as long distance customers, a share of 21%.[94] SBC subsequently stopped releasing long distance market share figures on a state-by-state basis, so further state-level comparisons is no longer possible. Absent effective competition in the local market, Verizon's continued dominance of the DC local market will diminish competition and result in remonopolization of the DC long distance market as well.

76. The development of effective competition for local services, including residential and small business, is critical to forestall remonopolization of the long distance market following Verizon DC entry in-region. As long as Verizon is permitted to exploit its captive relationship

92. Extrapolating from this figure, it would not surprise me for Verizon's long distance market share in New York to approach 60-70% within five years following 271 authority.

93. Verizon Press Release, January 31, 2002.

94. *SBC Investor Briefing*, dated April 23, 2001, p. 7, provided in Attachment OPC A-4.

with the vast majority of local service customers to market and sell its affiliate's long distance services. Verizon long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous decline in customers and demand. Faced with such losses. IXC costs will rise and at least some IXCs will be forced to exit the business. further exacerbating the situation and affording the BOCs an even greater opportunity to remonopolize the nation's long distance market. Therefore. before recommending approval of Verizon DC's filing for Section 271 authorization by the FCC. this Commission has the authority and obligation to implement all measures. including restrictions on Verizon's use of the inbound channel, that it believes necessary under both federal and DC law to ensure full competition in the intrastate interLATA market

> Verizon's provision of joint local and long distance billing as well as 'tie-in" discounts when customers purchase combinations of local and long distance services demonstrate that VLD does not view pavments it makes to the Verhon BOCS as "costs" if such payments have no material impact upon the consolidated Verhon Communications, lnc. bottom line.

Where the payment by VLD exceeds the actual cost to the BOC. that "cost" to the affiliate is offset by a "profit" to the BOC. which means that the actual "cost" to the consolidated enterprise will be less than the "cost" that is recorded on VLD's books. Indeed, in some cases the "cost" to the consolidated enterprise may well be at or near zero. This would be the case where, for example. the additional cost to the BOC to include VLD's requirements in something that it is doing anyway is negligible. One example of this is in the billing and collection function. The BOC is going to print and mail a local service bill and process the payment it receives from its local service customer. Including the VLD long distance charges on such billing statements will not require additional envelopes and will rarely require additional postage, and the cost of processing of the payment will be unaffected by the inclusion of long distance charges.

78. As a structurally separate affiliate required to maintain an "arm's length" relationship with the BOC. VLD should be looking only to the costs that it records on its own books. not to the usually much lower costs to the consolidated enterprise. It appears, however. that VLD is actually doing the latter, and in so doing is gaining an enormous competitive advantage vis-a-vis its rivals who must incur the same types of costs on an entirely stand-alone basis..

79. According to the Section 272(b)(5) disclosure information provided on Verizon's website, Verizon DC's charge to Verizon Long Distance for billing and collection services is approximately $1.10 per account (plus postage. which varies based on weight).[95] Since the incremental cost to Verizon DC for these services is at or near zero. virtually all of the $1.10 cost to Verizon Long Distance represents "profit" to Verizon DC; from the standpoint of the consolidated enterprise. then. any such "payments" by one entity to another are essentially a "wash" and can be ignored. By contrast, other long distance providers not affiliated with Verizon's existing relationship with local customers. will incur real out-of-pocket costs for the billing and collection functions. whether purchased from Verizon at the same terms as are nominally being "offered to Verizon Long Distance. or are accomplished via stand-alone billing and collection activities undertaken by the IXC.

95. http://www.verizonld.com/pdfs/VLDTransactionDetailWebPage1.pdf, (accessed 9/24/02)

80. If Verizon Long Distance was truly maintaining an arm's length, separate affiliate relationship with Verizon DC. it would be forced. when setting its own retail prices. to give effect to these account-specific payments to Verizon DC as representing out-of-pocket *costs*. Verizon DC would find it far more difficult for example, to offer non-monthly-fee discount rate plans if it were subject to fixed per-account expenses. However, despite the fact that these billing costs are the similar or exactly the same for all Verizon jurisdictions. Verizon Long Distance introduced precisely this type of pricing as soon as it was permitted to begin offering interLATA services in New York and has maintained this same pricing policy both in New York and in other Verizon 271 jurisdictions ever since.

81. It is also instructive to compare and contrast Verizon's inter-entity pricing practices as between billing and collection services, on the one hand. and customer acquisition/joint marketing services. on the other. Since Verizon BOCs offer and provide billing and collection services to nonaffiliated IXCs. it is required to "charge" the same price for such services to its 272 affiliate as it does with respect to equivalent services furnished to nonaffiliated entities.[96] Not surprisingly. the Verizon BOC "price" for these services has been set at "fair market value." well in excess of its actual incremental cost. By contrast. Verizon BOCs are *not* required to provide "joint marketing" services to nonaffiliated IXCs.[97] and by extension is not required to "offer" comparable or nondiscriminatory terms and conditions with respect to such services to nonaffiliated entities. In this situation. Verizon BOCs price these services at what it claims to be

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96 47 U.S.C §272(c)(1).

97 47 U.S.C. §272(g).

fully-distributed cost (as Verizon DC has already done in at least one case).[98] resulting in a one-time per-transaction "price" that is a small fraction of the fair market value of the customer acquisition services that it provides to Verizon Long Distance.

82. This disparity results from the FCC's affiliate transaction rules, as applied to Section 272 Affiliates by the *Accounting Safeguards Order*. Services provided to the Section 272 Affiliate by the BOC must be priced based on (1) Tariff Price, (2) Prevailing Market Price (PMP) or, if neither of the first pricing options apply, (3) the higher of fully distributed cost or fair market value.[99] Joint marketing services, since they are not available to competitors, have no tariff or PMP price. Verizon's claim that a fair market value cannot be estimated for these services leaves it to price joint marketing services at fully distributed cost. The significant *underpricing of* joint marketing prevents hundreds of millions of dollars[100] from flowing, on paper, from the Section 272 Affiliate to the BOC, which would assuredly trigger a Commission proceeding into the validity of the Verizon BOC's local rates, considering the earnings experience by the Verizon BOC.

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98. *See* footnote 74, *supra*.

99. *Accounting Safeguards Order*, 11 FCC Rcd 17607

100. For example, I stated above that I am aware of studies that estimate long distance customer acquisition costs at between $300 and $600 per customer. However, even if customer acquisition costs are as low as $100 per customer, by paying $7.71 for each customer acquisition, Verizon Long Dinance has avoided $92.29 of acquisition costs for each customer. Verizon reponed that as of the first quarter of 2002 it had 2.4 million long distance customers in New York. *See* http://investor.verizon.com/news/VZ/2002-04-23_X839573.html, accessed 9/25/2002. Conservatively, we can estimate the Verizon Long distance has avoided at least $222 million by paying for joint marketing services on a fully distributed cost basis rather than a fair marker value basis.

83. Alternatively, since the Verizon operating companies sell more than 50% of their billing and collection services to IXCs other than Verizon Long Distance. Vcrizon is able to price billing services at PMP. What Verizon has done is set the price for billing and collection high enough that other IXCs must consider the price when offering consumer pricing plans. but not so high as to prevent competing IXCs from offering combined local and long distance billing to the customers who value the service. In this way, Verizon ensures that (I) it maintains IXC purchase of billing services at the 50% or more threshold. but (2) Vcrizon Long Distance is the only long distance company that can afford to offer consumer pricing plans that do not include a means of recovering billing costs.

84. Consider the types of "tie-in" arrangements that Verizon Long Distance and Verizon New York have pursued as pan of their "joint marketing" program.[101] In New York. Verizon Long Distance was offering a $4.60 credit when a customer selected the basic Schedule "C" ($0.10 per minute. no minimum. no monthly charge) calling plan and also subscribed to the Verizon BOC's "Value Pack" service. a package of local exchange service and selected vertical features.[102] The Schedule C rate plan was targeted at the relatively low-use customer who would be attracted by the absence of either a monthly charge or minimum usage commitment. If. for example. such a customer were to make no long distance calls at all during a given month.

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101 OPC sought to examine copies of Verizon DC's marketing/sales scripts that the Company expects to use as pan of its joint marketing program. See OPC data request to Verizon DC 1-176. 1-177 and 1-178. Verizon DC objected to these requests, and to date has not provided any of the requested materials.

102. Bell Atlantic Communications. Inc. d/b/a Verizon Long Distance, New York PSC Tariff No. 1. Original Promotional Anachment No. 5. Package No. 1 Promotion and Rate Schedule (Section 3.5.3).

Verizon Long Distance would sustain a "loss" of at least $4.60 in that it would still have to "pay" the credit to Verizon New York while receiving no offsetting long distance revenue from the customer. Verizon New York. however. would realize $17.99 in actual revenues from the customer (the price of Value Pack service)[103] plus the additional $4.60 "payment" from Verizon Long Distance. Verizon New York gains $22.59 while Verizon Long Distance "loses" $4.60, which still results in a net gain to the consolidated Verizon bottom line of $17.99, erasing the Verizon Long Distance "loss" when examined at the parent level. Verizon Long Distance's ability to offer this "promotion" and to potentially sustain the "losses" arising therefrom is solely and uniquely attributable to its affiliate relationship with the Verizon BOC. From the perspective of any *competing* non-affiliated interexchange carrier attempting to make a comparable "promotional" offer, that same $4.60 "payment" would be a real *cash payment*, representing a true out-of-pocket cost to the IXC. In Verizon's case. even though the inter-affiliate "payment" is (presumably) actually being recorded on the two entities' respective books. Verizon Long Distance is behaving as if no such "payment" is actually taking place. Were Verizon DC to engage in similar "promotional" or "tie-in" offers. the effect would be to impose an anticompetitive price squeeze on its long distance rivals as well.

103 http://www22.verizon.com/foryourhome/SAS/StateSelector.asp?ID=choosefeat, accessed 9/25/2002.

The Section 272 affiliate is abk to shift the costs of recruiting and hiring qualified employees by recruiting BOC employees with the assistance of the BOC.

85 Section 272(b)(5) requires that all goods and services offered by the BOC to the Section 272 Affiliate be reduced to writing. compensated according to the FCC's affiliate transaction rules. and made available to all competitors on the same terms and conditions. By transferring employees from the Verizon operating companies to Verizon Long Distance. Verizon BOCs arc providing a service to the Verizon Long Distance affiliate that follows none of those requirements[104] By an outright transfer of employees from the Verizon BOC to Verizon Long Distance. Verizon Long Distance also has access to a highly trained and experienced workforce it obtains without recruitment or training costs. At least one state commission has determined that. with regard to any BOC employee transferred to an affiliate, the affiliate gains intangible value from the BOC. and the BOC is therefore entitled to compensation for that value. Specifically. the California PUC concluded:

> Our basic transfer pricing theory has been to charge the affiliate the higher of cost or market value for transferred services. In this way. we protect ratepayers by assuring that the utility treats an affiliate just as it would any orher unaffiliated firm: that is. charge what the market will bear. but decline the transaction if the market will not pay at least the cost of providing the transferred service.[105]

104 Under the "Training and Research" section of the Marketing and Sales Agreement setting "Further Compensation – Business." Verizon LD appears to have contracted for Verizon DC's provision of services to "Recruit & Hire New Employees." See footnote 74, *supra*. It is unclear whether these new employees are to be employees of Verizon DC, VLD, or some other entity In addition. the contract *sets* the rate for this service at $2.500, an amount that appears to be woefully short of charges a headhunter would apply.

105 California Public Utilities Commission. D.87-12-067, 27 CPUC2d 1, 136.

The California PUC adopted a 25% "employee transfer fee" to be applied against the annual salary of any Pacific Bell employee that is transferred to an affiliate.[106] Verizon DC does not currently pay any employee transfer fee for employees that are moved from the BOC to Verizon Long Distance.

86. That this Commission can expect significant transfers of personnel from Verizon DC to Verizon Long Distance may be inferred from Verizon conduct in other states. The Verizon New York Audit indicated that. from a random sample of 90 employees, the Company transferred 12 employees to a Section 272 affiliate since February, 1996. No employees were transferred in the opposite direction, from a Section 272 Affiliate to Verizon New York.[107]

This Commission should view Section 272 as a whole, and ensure that the ability of the structural separation safeguards to constrain the potential for anticompetitive conduct are not compromised.

87. The overall Section 272(a) separate affiliate requirement and the five subsections of 272(b) collectively outline a comprehensive code of conduct that must be interpreted as rejecting *integrated* operations in both the network and non-network functions of the BOC and long distance entities.

88 The management and Board of Directors of Verizon Communications Inc., the parent company of the Verizon BOC and Verizon Long Distance entities, is ultimately responsible to

106. *Id*

107. *New York Audit Report*, Appendix A. at p. 10.

Verizon's shareholders. As such, the parent company's role is to make decisions that are in the best interests of the overall corporation. even if such decisions may adversely affect the fortunes of individual components thereof. Thus. and absent the "arm's length" transaction requirement of Section 272(b)(5). the Verizon parent company may determine that it should sacrifice profits in one subsidian to benefit another if by so doing it could increase overall corporate profits. For example. if the 272 Affiliate were able *to* purchase services or obtain information from the BOC entity at less than fair market value (or for "free"). the affiliate could then underprice its competitors. allowing it to capture market share and realize higher overall corporate profit. But an "am's length transaction" requirement obligates each of the entities to operate vis-a-vis each other not with the goal of maximizing *corporate* profits, but rather with the objective of *maximizing profits in each of the affiliate entities on o stand-alone basis*. The "arm's length" requirement thus precludes the BOC entity. for example. from affording favorable treatment to the 272 Affiliate if by so doing the financial or business interests of the BOC entity would be compromised even *if the overall financial or business interests of the parent Verizon Communications Inc would be enhanced.* Thus. the 272(b)(5) requirement works to impose a separaiion of fiscal goals with respect to *all* facets of the *separate* BOC's and its 272 Affiliate's activities and operations. *even where that causes overall Verizon corporate profits to be less rhan they would be under fully inregrated operotions with all transactions between and among affiliates based upon rhe best inrerests of the parent corporation rather than the best interests of each affiliate standing on its own.*

[89] A recently released empirical study of Verizon and SBC pricing following their receipt f Section 271 authority in New York and Texas, respectively, suggests that in both instances the

BOC ILEC entity and the Section 272 structurally separated long distance affiliate are not maintaining the "arm's length" relationship that is required by Section 272(b)(5) and, more generally, are operating vis-a-vis one another ***as if the Section 272(a) and (b) structural separation requirements did not exist.*** The study, "Does Bell Company Entry into Long-Distance Telecommunications Benefit Consumers?" by Jerry A. Hausman, Gregory K. Leonard, and J. Gregory Sidak,[108] claims to have found "a statistically significant decrease of 8 to 12 percent in the average bill in states where BOC entry occurred as compared to the states without BOC entry."[109] I have examined the so-called empirical basis for the authors' various contentions and have identified a number of serious, indeed, fatal deficiencies in their analysis.[110] Nevertheless, the study, which was commissioned by Qwest in support of its Section 271 applications,[111] advances a theoretical basis for the empirical results they claim to have obtained.

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108. Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), unpublished study presented at the Department of Justice Telecom Workshop, *"The Drivers and Significance of Competition in Local Telecommunications: Empirical Evidence,"* Washington, DC, July 23, 2002.

109. *Id.*, at 2.

110. Selwyn, Lee L., "BOC Long Distance Entry Does Not Benefit Consumers," presented at the Department of Justice Telecom Workshop "The Drivers and Significance of Competition in Local Telecommunications: Empirical Evidence," July 23, 2002. Available at http://www.econtech.com/library/DOJ_072302.pdf.

111. Although the authors do not cite the source of their funding in the paper, evidence adduced in the current Section 271 proceeding in Minnesota has identified Qwest as that source. *In the Matter of a Commission Investigation into Qwest's Compliance with Section 271(d)(3)(C) of the Telecommunications Act of 1996 that the Requested Authorization is Consistent with the Public Interest Convenience and Necessity*, Before the Minnesota Public Utility Commission, PUC Docket No. P-421/CI-01-1373, Qwest response to

(continued...)

If the authors' empirical findings and claims are accurate, however. the theoretical "double marginalization" explanation for this outcome would indicate that Verizon in New York is in violation of the separate affiliate requirement.

90. Hausman *et al* explain -'double marginalization" as follows:

> Double marginalization occurs when two companies have a vertical supplier-customer relationship. The upstream company *sets* its margin to maximize its profits individually, while the downstream company does the same. If the upstream company begins to offer the downstream product also, it generally will set the final price of the downstream product to maximize its profits jointly. The company offering the combined product will often find that it can increase its profits by lowering the price of the final product below the combined price that [sic] would obtain in the previous situation.
>
> Suppose that a BOC's incremental margin on the provision of network access is $0.02 per minute. while the IXC's incremental margin on residential long-distance service is $0.04 per minute. The BOC will find it to be profit maximizing to lower the total margin from 50.06 per minute because it earns both margins. rather than only a single margin (50.02 for access + $0.04 for long-distance = 50.06 total margin). The BOC would also be using two sets of facilities. local access and long-distance facilities. to cam this higher margin. When the BOC decreases the price slightly. it sells more access and more long-distance services and earns approximately 50.06 per minute. In contrast, if an IXC decreases the price. it only receives the additional margin from increased sales of long-distance service of 50.04 per minute. Thus. the BOC has a greater incentive to charge lower long-distance prices than does an IXC. Furthermore. when the BOC lowers the long-distance price. the IXCs will lower their prices. which will increase the number of long-distance minutes demanded and consequently the number of access minutes demanded from the BOCs.

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111. (...continued)
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91. Of course, such "double marginalization" will occur as between the BOC and its 272 affiliate *only when the two entities seek to maximize their joint profit — i.e.. when they explicitly do nor deal wirh each other at arm's length* as expressly required by Section 272(b)(5). and instead pursue a strategy that converts the "wall" that the *Act* sought to create between the BOC and long distance entities into a transparent and porous membrane whose purpose is entirely limited to serving as the demarcation point for the required compliance postings and filings. The intenr of the statute is to assure that the BOC's long distance affiliate gains no competitive advantage vis-a-vis nonaffiliated IXCs. which implies that it should view all payments to the BOC for both tariffed (*e.g.*, access) and non-tariffed services as "costs" and make all pricing and output decisions without regard to the fact that such "payments" to the BOC will create offsetting profits in the BOC entity itself.

92 Theoretically. a CLEC would be able to enjoy the same double marginalization benefits as a BOC. *but only once the BOC has lost its marker power in rhe local marker.* Verizon's ability to gain significant long distance market share is undoubtably due to its local market power. As I have discussed above. the pricing plans being offered by the BOC Section 272 affiliates are premised upon the ability of the BOC and its Section 272 affiliate to operate as if interaffiliate payments for fixed costs such as billing did not exist. Virtually all marketing costs associated with customer acquisition were avoided by the Section 272 affiliate, despite the clear requirement of Section 272(b)(5) that the BOC marketing services should have resulted in arm's length marketing fees paid by the 272 affiliate to the BOC. Avoiding these costs is the only economic reason why the BOC interLATA affiliates are able to offer pricing plans such as their no-minimum. no-monthly fee offer.

93. BOC local market power allows integrated offers that simply me not possible for competitors to match. As the default local service provider. the BOCs do not need to engage in additional advertising or customer acquisition costs to attract local customers. and once the local customers are acquired, the BOC is allowed to preemptively sell the customer the affiliate's long distance service. Even assuming that CLECs were able to attract a market share approaching that of the BOCs. the CLECs relatively new position in the local market docs not allow the CLEC to enjoy similar cost avoidance. While a CLEC's long distance service would enjoy similar customer acquisition and billing benefits as the BOC affiliate, the CLEC's *local* service provision would be required to incur massive marketing outlays in order to attract local customers. at costs that are likely to be similar to or higher than those required to attract long distance customers. Those marketing costs. unique to CLECs. would increase the CLECs' cost of providing service above that of the BOC.

94. The purpose of Section 272 was to prevent exactly this kind of integrated pricing until CLECs were similarly positioned to take advantage of the same type of economies. CLECs will not be so positioned until the BOC no longer enjoys market power in the local market. As long as rhr BOC is permitted to exploit its captive relationship with the vast majority of local service customers to market and sell its affiliate's long distance services, BOC long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous decline in customers and demand. Faced wirh such losses. IXC costs will rise and at least some IXCs will be forced to exit the business. further exacerbating the situation.

95. The Commission should direct Verizon DC to implement the following Section 272 practices. or else find that the Company docs not meaningfully intend to comply with the consumer and competitive safeguards of Section 272.

(1) The Commission should prohibit improper self-dealing by requiring that Vcrizon DC file with the Commission and make available for public inspection all fair market value studies undertaken, including a study estimating the fair market value of joint marketing and customer acquisition services. and the complete process and data used to determine the fully distributed cost for services priced under either of these two methods. If Verizon fails to make such a filing. it should not be permitted to provide the service in question. In addition, the Commission should direct the auditor, during the joint federal-state biennial Section 272 audit proceeding. to examine all of these filings, not just a random sample.

(2) The Commission should apply non-solicitation rules to the transferring or movement of employees from Verizon DC to Verizon Long Distance. While employed at Verizon, no employee of any Verizon entity should request or solicit an employee of Verizon DC. or cause another employee of Verizon DC to be solicited. to transfer or move employment from Verizon DC to Verizon Long Distance. Verizon should not post in Verizon DC offices or on Verizon electronic medium. or allow Verizon Long Distance to post in Verizon offices or on Verizon intranets or other electronic media. advertisements for or notices of availability of Verizon Long Distance positions.

(3) The Commission should find that, as long as Verizon DC has market power in the local market. it is able to artificially inflate the "Prevailing Market Price" of billing and collection services offered to competing IXCs. The Commission should require that Verizon DC price billing and collection services provided to Verizon Long Distance at the lesser of fully distributed cost or fair market value. and made available to competitors at the same price.

96. The Commission should strengthen the affiliate transaction Nles by directing the affiliates to operate such that the management of each entity (Verizon DC and Verizon Long Distance) each make all affiliate transaction, service offering, and pricing decision only with respect to the bottom line of each respective entity. For example, Verizon Long Distance should not be permitted to ignore the per-account billing fees it pays to Verizon DC when offering service plans that do not include fixed or minimum monthly charges. Such plans. if offered by Verizon. would effectively negate the "am's length" relationship by substituting the actual out-of-pocket costs to the parent Verizon Corporation for the incremental long distance billing (which are minimal) for the "payments" that Verizon Long Distance is nominally required to make to Verizon DC for the billing services. Where the parent corporation balance sheet is the only consideration. Verizon DC and Verizon Long Distance will continue to cost-shift wherever possible so as to establish false competitive prices or prevent Verizon DC from earning income from affiliate transactions that could ultimately be used as a basis for Verizon DC to seek rate increases for its regulated monopoly services either by revising its price cap structure or by some other 'extraordinary" form of "relief."

Through press releases, Verizon DC trumpets the consumer benefits of its entry into the DC long distance market, yet fails to validate these allegations to the Commission.

97. On July 12, 2002, Verizon issued a News Release announcing the filing of its 271 application with the DC PSC.[112] In that press release, Verizon claimed that its entry would result in substantial consumer benefits, claiming that, "[c]onsumers are saving as much as $1.8-billion annually from local and long distance competition associated with Verizon's entry into the long distance markets."[113] According to that same document the alleged savings are derived from "studies analyzed by Verizon" that were "based on projections from a variety of independent economists and consumer watchdog groups."[114] Neither the "independent economists" nor the "consumer watchdog groups" were identified by Verizon. Moreover, none of these "analyses" of the unidentified "studies" or the "studies" themselves were included or discussed in any of the Verizon testimony that has been identified, submitted to the Commission, or defended in this proceeding

98. However, in a number of its other Section 271 proceedings, Verizon identified the "independent economists" and/or the "consumer watchdog groups" behind the purported "consumer savings" that Verizon seeks to ascribe to its entry into the long distance market. The "consumer watchdog group" to which Verizon refers is an organization identifying itself as the

112. "Verizon Asks PSC to Support Company's Request To Offer Long Distance in Nation's Capital." Verizon New Release. July 12, 2002, a copy of which appears in Attachment OPC A-2.

113. *Id.*

114. *Id*